

11 U.S.C. § 502(b)(6)  
"As is" provision  
Recoupment

In re Americold Corporation, Case No. 395-33058-elp11

7/15/96

ELP

Unpublished

Lessor and debtor filed cross-motions for summary judgment on various issues relating to rejection of a non-residential lease in debtor's Chapter 11 case. The court held that, whether or not rejection of a lease constitutes termination of it, the damages for rejection are governed by § 502(b)(6). "Rent reserved," as used in § 502(b)(6), must be determined by the three-part test set out in In re McSheridan, 184 BR 91 (9th Cir BAP 1995). All damages arising from breach of the lease agreement are capped by § 502(b)(6). Claims for damages that are independent of the obligations set out in the lease are not within the cap of § 502(b)(6). The test for "rent" under § 502(b)(6)(A) is the same as the test for "rent" under § 502(b)(6)(B).

The provision of the lease that allowed the lessee to return the property to the lessor "as is" did not apply, because that provision applied only at the first option expiration date, which had not yet arrived at the time debtor filed Chapter 11.

Lessor is entitled to recoup all of its damages against amounts it owes debtor, regardless of any § 502(b)(6) limitation. Recoupment is not limited by § 553 to the amount of the allowed claim. The amount lessor owes to debtor on a promissory note will be deducted first from lessor's entire lease rejection claim, not first from the allowed claim.

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UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF OREGON

In Re: ) Bankruptcy Case No.  
 ) 395-33058-elp11  
AMERICOLD CORPORATION, )  
 ) MEMORANDUM OPINION  
Debtor. )

TSEW Realty, Inc. and Carter Associates ("Lessor") filed a proof of claim for damages arising out of debtor's<sup>1</sup> rejection of its lease with lessor. Debtor objected to the claim and filed a motion for partial summary judgment. Lessor has made a cross-motion for partial summary judgment on essentially the same issues.<sup>2</sup> The court

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<sup>1</sup> For ease of reference, I will refer to Americold as "debtor," even though it became debtor in possession ("DIP") upon the filing of the Chapter 11 petition.

<sup>2</sup> Lessor argues that I should deny debtor's motion because debtor failed to file a concise statement of material facts as required by the local rules. I decline to deny the motion on that basis. This motion addresses primarily legal issues rather than a determination of how the law applies to particular facts. Debtor's failure to file a concise statement

(continued...)

1 held argument on the motions on June 4, 1996. Both parties appeared  
2 through counsel. At the hearing, I gave counsel a draft ruling.  
3 This opinion reflects my decision on the motions after hearing  
4 argument and obtaining additional briefing on some issues.

5 BACKGROUND FACTS

6 In 1967, Beatrice Foods Co. entered into a lease with  
7 lessor's predecessor in interest for the long-term rental of a  
8 refrigerated warehouse in Chicago. In 1986, debtor succeeded to the  
9 interest of Beatrice under the lease. The lease is a "triple net"  
10 lease under which the lessee is responsible to pay base rent plus  
11 "additional rent." In 1994, as a result of a dispute that arose  
12 regarding the lease, lessor and debtor entered into a settlement  
13 agreement. The agreement amended certain terms of the lease, and  
14 included a note by which lessor agreed to pay debtor \$515,000.

15 Debtor filed a Chapter 11 petition on May 9, 1995. Debtor,  
16 as DIP, rejected the lease effective September 18, 1995. Lessor  
17 filed a proof of claim, seeking damages for basic rent and  
18 additional rent, including real estate taxes and ground rent, for  
19 the remainder of the lease term, plus what lessor labels  
20 "environmental remediation costs." Debtor objected to the claim,  
21 arguing that the claim is capped by 11 U.S.C. § 502(b)(6) and does  
22 not include damages other than reserved rent. The parties also seek  
23 summary judgment on the ability of lessor to offset or recoup  
24

25 \_\_\_\_\_  
26 <sup>2</sup>(...continued)  
of facts has not hindered the resolution of the motion.

1 amounts it owes debtor from amounts debtor owes it. Finally, debtor  
2 requested that lessor's right to assert new claims or to amend its  
3 proof of claim be limited to a date certain. The issue of limiting  
4 lessor's right to assert new claims or amend its proof of claim was  
5 resolved at a separate hearing and will not be addressed in this  
6 Memorandum Opinion.

#### 7 ISSUES

8 1. Is lessor's claim subject to the cap of 11 U.S.C. §  
9 502(b) (6) ?

10 2. If the claim is subject to the cap,

11 (a) what damages are included as "rent reserved" in  
12 calculating the cap?

13 (b) can lessor assert a claim for other damages in addition  
14 to the capped reserved rent?

15 3. Is lessor required to accept the surrendered property in "as  
16 is" condition?

17 4. Is lessor entitled to offset or recoupment?

#### 18 DISCUSSION

19 1. Is lessor's claim subject to the cap of 11 U.S.C. §  
20 502(b) (6) ?

21 11 U.S.C. § 502(b) provides, in part, that the court shall  
22 allow a properly filed claim except to the extent that:

23 "If such claim is the claim of a lessor for damages  
24 resulting from the termination of a lease of real property,  
such claim exceeds --

25 "(A) the rent reserved by such lease, without  
26 acceleration, for the greater of one year, or 15  
percent, not to exceed three years, of the remaining

1 term of such lease, following the earlier of --

2 "(i) the date of the filing of the petition;  
3 and

4 "(ii) the date on which such lessor  
5 repossessed, or the lessor surrendered, the leased  
6 property; plus

7 "(B) any unpaid rent due under such lease, without  
8 acceleration, on the earlier of such dates[.]"

9 Lessor does not dispute that its lease with debtor is a "true lease"  
10 to which § 502(b)(6) could apply. Lessor argues, however, that §  
11 502(b)(6) applies only when a lease is terminated, and that this  
12 lease was not terminated but was instead rejected pursuant to 11  
13 U.S.C. § 365(a). Because, under § 365(g), rejection of an unexpired  
14 lease "constitutes a breach of such \* \* \* lease," lessor argues that  
15 the lease was breached, not terminated. Debtor responds that  
16 rejection of the lease constituted termination of it, and therefore  
17 § 502(b)(6) applies to limit lessor's damages.

18 The cases are divided on whether rejection results in  
19 termination of a lease or constitutes only a breach of the lease.  
20 Compare Picnic 'N Chicken, Inc., 58 BR 523 (Bankr SD Cal 1986) and  
21 Matter of Austin Development Co., 19 F3d 1077 (5th Cir), cert denied  
22 115 S Ct 201 (1994) (rejection does not constitute termination),  
23 with In re Port Angeles Waterfront Associates, 134 BR 377 (9th Cir  
24 BAP 1991) (once rejected, a lease is terminated). The Ninth Circuit  
25 has not directly addressed the issue. In Sea Harvest Corp. v.  
26 Riviera Land Co., 868 F2d 1077 (9th Cir 1989), the court considered  
whether the debtor in possession needed court approval for rejection  
when the debtor did not timely file a motion to assume leases of

1 tidelands. The court held that court approval was not necessary,  
2 because under § 365(d)(4), a lease of nonresidential real property  
3 under which the debtor is lessee is deemed rejected if the trustee  
4 does not assume or reject the lease within 60 days after the order  
5 for relief. The court noted that, under § 365(d)(4), upon deemed  
6 rejection, the trustee must "immediately surrender" the real  
7 property to the lessor. The court said that surrender of property  
8 "has the effect of terminating the enterprise that operates there."  
9 868 F2d at 1080. Courts have read that language as a holding that a  
10 lease, once rejected, is terminated. See Port Angeles Waterfront,  
11 134 BR at 380.

12 I do not read Sea Harvest as holding that rejection of a  
13 nonresidential real estate lease is termination of the lease for all  
14 purposes. First, the language at issue was dicta. Second, the  
15 court said that rejection terminated the enterprise that operated on  
16 the leased property. That is not the same as saying that the lease  
17 itself is terminated. Similarly, the court's language in In re  
18 Harris Pine Mills, 862 F2d 217, 219 (9th Cir 1988), that rejection  
19 of an unexpired nonresidential lease "results in termination of the  
20 lease," is also dicta. Finally, I do not read Port Angeles  
21 Waterfront as holding that rejection of a nonresidential real  
22 property lease constitutes termination of it. The issue in that  
23 case was whether the debtor was obligated to surrender the leased  
24 premises after the lease was deemed rejected pursuant to §  
25 365(d)(4). Section 365(d)(4) clearly requires surrender, whether or  
26 not the lease is considered to have been terminated by the deemed

1 rejection.

2 I conclude that I need not decide whether rejection of a  
3 nonresidential lease of real property results in termination of it.  
4 The issue in this case is whether § 502(b)(6) applies. Even though  
5 § 502(b)(6) refers to termination of a lease, the cases universally  
6 hold that a lessor's damages for rejection of an unexpired lease are  
7 limited by § 502(b)(6), regardless of whether the lease is  
8 considered to be terminated or only breached. See, e.g., Matter of  
9 Austin Development Co., 19 F3d 1077 (5th Cir 1994); In re Emple  
10 Knitting Mills, Inc., 123 BR 688 (Bankr D Me 1991). Lessor cites no  
11 cases that have held that the limitation of § 502(b)(6) does not  
12 apply to a landlord's claim for damages upon rejection of a real  
13 property lease, and I am unaware of any such cases. Even Austin  
14 Development Co., on which lessor does rely, acknowledges that the  
15 creditor on a rejected lease "may be subject to a cap." 19 F3d at  
16 1082. In In re Mr. Gatti's, Inc., 162 BR 1004, 1011 (Bankr WD Tex  
17 1994), the court said:

18 "[W]hen a debtor files bankruptcy, any interest that it has  
19 in an unexpired lease of real property would certainly become  
20 property of the estate. 11 U.S.C. § 541. The estate \* \* \*  
21 then has two options -- it may assume the lease or it may  
22 reject the lease. \* \* \* It is only where the bankruptcy  
23 estate rejects its obligation to perform any further under an  
24 unexpired lease of real property that the landlord becomes  
entitled to file a proof of claim. \* \* \* § 365(d)(3),  
365(d)(4) and 502(b)(6) when 'read together', are part of a  
total scheme designed to set forth the rights and obligations  
of landlords and tenants involved in bankruptcy proceedings.  
In accord, see Moreggia & Sons, Inc., 852 F2d 1179, 1182 (9th  
Cir 1988)."

25 I agree with that reasoning.

26 2. Application of § 502(b)(6).

1       (a) What damages are included in "rent reserved?"

2       A landlord's claim for damages resulting from termination of  
3 a lease of real property is capped at one year or 15 percent of the  
4 "rent reserved" in the lease. Debtor argues that "rent reserved"  
5 should be determined according to the test set out in In re  
6 McSheridan, 184 BR 91 (9th Cir BAP 1995). Under that formulation,  
7 debtor acknowledges that "rent reserved" includes net basic rent of  
8 \$229,810 per year, ground lease rent of \$17,000 per year, and real  
9 estate taxes of at least \$46,421 per year. Lessor argues that, in  
10 addition, "removal, alteration, maintenance, repair and restoration  
11 expenses" should also be included in "rent reserved."

12       "Rent reserved" is not defined in the Code. In McSheridan,  
13 the BAP considered the precise issue presented here: what damages  
14 arising from the rejection of a triple net lease are included in the  
15 definition of "rent reserved" as used in § 502(b)(6). After  
16 discussing a number of cases, which have taken varying approaches,  
17 the BAP concluded:

18               "We hold that the following three-part test must be met  
19               for a charge to constitute 'rent reserved' under § 502(b)(6):

20               "1) The charge must: (a) be designated 'rent' or  
21               'additional rent' in the lease; or (b) be provided as the  
22               tenant's/lessee's obligation in the lease;

23               "2) The charge must be related to the value of the  
24               property or the lease thereon; and

25               "3) the charge must be properly classifiable as rent  
26               because it is a fixed, regular or periodic charge."

184 BR at 99-100.

Lessor disagrees with that test and argues instead that "rent



1 reserved" encompasses all charges in the lease that have a  
2 relationship to the value of the property and the value of the  
3 lease. See In re Roses Stores, Inc., 179 BR 789 (Bankr EDNC 1995);  
4 In re Hecks, Inc., 123 BR 544 (Bankr SD WVa 1991). It then asserts,  
5 without further elaboration, that rent reserved under paragraphs 3  
6 and 4 of the lease includes at least the items conceded by debtor  
7 plus removal, alteration, maintenance, repair, and restoration  
8 costs.<sup>3</sup>

9 The parties dispute whether I am bound by the BAP decision in  
10 McSheridan. Whether or not bankruptcy courts are bound by the  
11 decisions of the BAP, it is my general policy to follow BAP  
12 decisions in order to provide predictability and to help achieve a  
13 uniform body of law throughout the circuit. The only exception to  
14 that policy is that I do not follow the BAP when its decision is  
15 contrary to Ninth Circuit Court of Appeals or Supreme Court  
16 authority. There is no contrary Ninth Circuit or Supreme Court  
17 authority on this issue. Therefore, I will follow the test set out  
18 in McSheridan for determining what costs are included in "rent  
19 reserved" for purposes of calculating the lessor's damages cap under  
20 § 502(b)(6)(A).

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22 <sup>3</sup> Paragraph 3 of the lease sets out the net basic rent for  
23 the property. Paragraph 4 of the lease sets out what is  
24 called "additional rent," and includes such items as, for  
25 example, real estate taxes, utility charges, insurance  
26 premiums, costs of removal of debtor's property upon  
termination, costs of alteration, maintenance and repairs to the  
property, including maintaining the property in good condition  
and repair.

1 Lessor argues that I should not follow McSheridan, because  
2 its test was formulated relying on the Washington statutory  
3 definition of rent. I disagree. Although the BAP mentioned that  
4 "Washington law also generally recognizes the common meaning of  
5 rent," 184 BR at 97, the panel considered various definitions and  
6 tests drawn from case law from numerous jurisdictions. The panel  
7 concluded:

8 "Reflecting on the above cases, it is apparent to the  
9 Panel that federal case law has caused the evolution of a  
test to determine rent reserved under § 502(b)(6)(A)."

10 184 BR at 99. The BAP did not rely on Washington state law in  
11 formulating its test for rent reserved.

12 Lessor argues in particular that I should reject the third  
13 prong of the test, that the charge be fixed, regular or periodic,  
14 and consider only whether the parties have designated the charge as  
15 rent in the lease. It asserts that there is no rational basis for  
16 the periodic payment requirement. Again, I disagree with lessor.  
17 The requirement that a charge be a fixed or periodic payment in  
18 order to constitute rent is one that existed at common law and that  
19 has been applied by other courts. See Black's Law Dictionary 1166  
20 (5th ed 1979); In re Farley, Inc., 146 BR 739 (Bankr ND Ill 1992);  
21 In re Conston Corp., Inc., 130 BR 449 (Bankr ED Pa 1991). Further,  
22 the requirement that the charges be fixed, regular or periodic is  
23 especially appropriate in the context of a determination of the  
24 limitation on landlords' claims under § 502(b)(6)(A), because the  
25 limitation has a temporal element: the rent reserved for one year.  
26

1 A charge that is fixed, periodic or regular can easily be converted  
2 into an amount that reflects its value for one year. I will apply  
3 the test set out in McSheridan.

4 Lessor provided the affidavit of Carl Valeri to describe the  
5 condition of the leased premises when lessor took possession.  
6 Attached to his affidavit is a schedule of expenses incurred as of  
7 April 15, 1996. That schedule includes costs for canopy erection  
8 and brick removal, ice and water removal, treatment of ammonia and  
9 calcium chloride, security guards, boarding up the property,  
10 electricity, environmental testing, insurance, and management and  
11 cleanup supervisory fees. The parties argue about whether debtor is  
12 obligated under the lease to pay those costs and, if so, which of  
13 those charges fit within the McSheridan test, and whether additional  
14 evidence is required in order to make those determinations.<sup>4</sup> I  
15 conclude that it is premature to decide at this juncture whether the  
16 lease requires debtor to pay specific costs and, if so, which of  
17 those particular charges are "rent reserved" under the lease.  
18 Application of the test requires evidence, which the parties have  
19 not yet developed. Debtor is entitled to partial summary judgment  
20 holding that "rent reserved" will be determined according to the  
21 test set out in McSheridan.

22 (b) Can lessor assert a claim for other damages in addition  
23 to the capped reserved rent?

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24 <sup>4</sup> The parties do not appear to disagree that, if debtor is  
25 responsible to pay the costs lessor asserts it must pay,  
26 debtor's liability is limited by the release to costs accruing  
on or after January 2, 1994.

1           (i) Are all the lessor's damages from breach of  
2           contract subject to the § 502(b)(6) cap?

3           Lessor argues that, even if the maintenance, repair and clean  
4           up costs are not included in rent reserved, they are nonetheless  
5           allowable because they are not damages arising from the termination  
6           of the lease and therefore are not capped by § 502(b)(6)(A). It  
7           urges me to adopt and follow In re Atlantic Container Corp., 133 BR  
8           980, 987 (Bankr ND Ill 1991), in which the court held that

9           "\$ 502(b)(6) is intended to limit only those damages which  
10          the lessor would have avoided but for the lease termination.  
11          Any damages caused to the Premises by the Debtor's failure to  
12          fulfill its repair and maintenance obligations are unrelated  
13          to the termination of the lease."

14          Debtor argues that all of lessor's damages are capped by the  
15          limitation of § 502(b)(6), relying again on McSheridan.

16          The BAP directly addressed this issue in McSheridan. The  
17          panel considered the decisions in Atlantic Container Corp. and In re  
18          Bob's Sea Ray Boats, Inc., 143 BR 229 (Bankr DND 1992), which  
19          followed the reasoning of Atlantic Container Corp. It concluded:

20                 "Despite the persuasiveness of the foregoing cases, the  
21                 Panel does not believe that the damages for breach of  
22                 covenants in this case is a separate claim from the  
23                 termination damages in general. \* \* \*

24                 "\* \* \* \* \*

25                 "[R]ejection of the lease results in the breach of each and  
26                 every provision of the lease, including covenants, and §  
27                 502(b)(6) is intended to limit the lessor's damages resulting  
28                 from that rejection. The damages are those resulting from  
29                 nonperformance of the debtor's obligations under the lease.  
30                 [In re Mr. Gatti's, Inc., 162 BR 1004 (Bankr WD Tex 1994)]. \*  
31                 \* \* [A]ll damages due to nonperformance are encompassed by  
32                 the statute."

33          184 BR at 101-02.

1 Lessor is correct that the court's opinion in Atlantic  
2 Container is well-reasoned. Nonetheless, I will follow the BAP's  
3 decision rejecting those arguments and reasoning until a higher  
4 court holds otherwise. Therefore, I conclude that lessor's post-  
5 rejection damages that do not fit the test for rent reserved are  
6 subject to the limitation of § 502(b)(6)(A). Debtor is entitled to  
7 partial summary judgment on that issue, and lessor's request for an  
8 order holding that damage claims resulting from events other than  
9 termination is denied.

10 (ii) Are lessor's damages alleged to arise from  
11 obligations outside the lease subject to the limitation of §  
502(b)(6)?

12 Lessor seeks summary judgment on the issue of whether damages  
13 caused by debtor's alleged breach of duties not arising under the  
14 lease, such as debtor's duty to comply with CERCLA and RCRA and to  
15 nonnegligently repair and not intentionally damage or waste the  
16 lease premises, are limited by § 502(b)(6). Debtor responds that it  
17 has no obligations to lessor arising from CERCLA or RCRA, and that  
18 lessor has failed to tie its claim to particular portions of the  
19 lease agreement. Further, debtor argues that all damages, even  
20 those allegedly arising from obligations outside the lease, are  
21 capped by the limitation of § 502(b)(6).

22 The parties do not cite, and I have not found, any cases  
23 addressing the precise issue presented here: whether the limitation  
24 of damages set by § 502(b)(6) applies to limit a landlord's damages  
25 related to the leased premises that purportedly arise from  
26 obligations imposed on the lessee outside the lease agreement.

1 Lessor relies on In re Bob's Sea Ray Boats, Inc., in which the issue  
2 was whether repair damages were included in the limitation set by §  
3 502(b)(6). The court held that § 502(b)(6) "does not address  
4 damages wholly collateral to the termination event--such things as  
5 waste, destruction or removal of leasehold property." 143 BR at  
6 231. However, the reasoning of that case, as well as of the case on  
7 which it relied, Atlantic Container Corp., was rejected by the BAP  
8 in McSheridan. Therefore, that authority does not assist lessor.

9 The reasoning of McSheridan and the cases on which it relies  
10 is that rejection of a lease constitutes breach of all of the  
11 covenants still requiring performance contained in the lease.  
12 Therefore, the limitation of § 502(b)(6) applies to all damages  
13 arising out of the rejection. That reasoning does not apply to  
14 claims a landlord could assert based on breaches of obligations that  
15 arise outside the lease and apart from rejection of the lease. The  
16 statute provides that it limits claims of a lessor "for damages  
17 resulting from the termination of a lease of real property."  
18 McSheridan reads that language as limiting all damages resulting  
19 from rejection of the lease. There is no language in the statute  
20 that could be read as also limiting a claim for damages arising from  
21 other than the lease. Therefore, I conclude that, to the extent  
22 lessor has claims for damages that are independent of the  
23 obligations set out in the lease, those claims are not within the  
24 cap of § 502(b)(6). In my view, if there are obligations to lessor  
25 that arise by operation of law, the fact that there may be a lease  
26 provision requiring debtor to comply with the law does not make

1 damages resulting from breach of those obligations damages resulting  
2 from rejection of the lease.

3 The parties argue about whether debtor is liable to lessor  
4 for costs imposed by CERCLA, RCRA and state law. It is not clear  
5 from the summary judgment record that any of lessor's asserted  
6 damages arise from those sources or, if there are damages arising  
7 from those sources, what those damages are. The summary judgment  
8 record is not sufficient to grant either party's motion on the issue  
9 of liability. Lessor is entitled to a determination that any  
10 damages caused by debtor's alleged breach of duties not arising  
11 under the lease are not limited by § 502(b)(6).

12 (iii) Section 502(b)(6)(B).

13 Lessor argues in its reply brief that McSheridan does not  
14 address the effect of § 502(b)(2)(B), which permits landlords to  
15 recover prepetition damages for "unpaid rent due" under the lease on  
16 the date the petition is filed, and therefore lessor is entitled to  
17 recover under § 502(b)(2)(B) those damages resulting from  
18 prepetition breach of the lease not caused by termination. As  
19 became clear at argument on these motions, lessor's position is that  
20 "any unpaid rent due under such lease" means anything designated in  
21 the lease as rent. According to lessor, if it can show that debtor  
22 had breached its repair and maintenance obligations prepetition,  
23 damages for breach of those obligations was "unpaid rent due under  
24 such lease" as of the date of the petition.

25 Lessor argues that the test for "unpaid rent due" under the  
26 lease under § 502(b)(6)(B) should be different from the test for

1 "rent reserved" under § 502(b)(6)(A). In particular, it asserts  
2 that the requirement attached to "rent reserved" that the payments  
3 be fixed, regular or periodic should not apply to determining what  
4 is rent due under a lease for purposes of § 502(b)(6)(B). Its  
5 argument apparently is based on the difference between the language  
6 of § 502(b)(6)(A), "rent reserved," and § 502(b)(6)(B), "unpaid rent  
7 due."

8 The cases and argument submitted in lessor's Supplemental  
9 Memorandum do not convince me that there is a principled basis for  
10 holding that rent means one thing under § 502(b)(6)(A) and another  
11 under § 502(b)(6)(B). In In re Q-Masters, Inc., 135 BR 157 (Bankr  
12 SD Fla 1991), on which lessor relies, the court calculated the  
13 amount under § 502(b)(6)(A) with reference only to the fixed monthly  
14 rent amount. It calculated the amount under § 502(b)(6)(B) by also  
15 including such costs as taxes, utilities and attorney fees, arriving  
16 at an amount for "unpaid rent." It then added on, as a separate  
17 category, costs of property damage. The court gave no explanation  
18 for its allowance of the prerejection property damage claim, and  
19 never discussed the pertinent language of the statute, "unpaid rent  
20 due" under the lease.

21 Similarly, the court in In re Clements, 185 BR 895 (Bankr MD  
22 Fla 1995), calculated the § 502(b)(6)(B) claim by adding all amounts  
23 due under the lease, including costs for maintenance. It reasoned  
24 that Congress intended that landlords be allowed a claim for their  
25 total damages, as limited by § 502(b), and that all sums due under  
26 the lease when the petition was filed should be included as part of



1 the claim.

2 Those cases are not persuasive. Both ignore the language of  
3 the statute, which refers to unpaid rent due under the lease.  
4 Neither case explains why property damage or maintenance costs  
5 constitute rent under the statute.

6 The operative language in both subparagraphs of § 502(b)(6)  
7 is "rent." The court in McSheridan decided what test would be used  
8 to determine what was "rent." It began its discussion of what was  
9 "rent reserved" by setting out definitions of "rent." 184 BR at 97.  
10 It concluded that "rent reserved" must meet a three-part test,  
11 including that "the charge must be properly classifiable as rent  
12 because it is a fixed, regular or periodic charge." 184 BR at 100  
13 (emphasis supplied). As I have said, a requirement that payments be  
14 fixed, regular or periodic is particularly appropriate in the  
15 context of § 502(b)(6)(A), which contains a temporal element. That  
16 does not mean, however, that the requirement is not appropriate in  
17 other contexts.

18 The fact that Congress used different language in connection  
19 with "rent" in the two subparagraphs is hardly surprising.  
20 Subparagraph (A) deals with future rent, which will be considered  
21 damages for breach of the lease. The rent must, however, be tied to  
22 the lease, hence the language "rent reserved by such lease." The  
23 qualifiers used in subparagraph (B), that the rent be due and  
24 unpaid, would never apply to an anticipatory breach. Subparagraph  
25 (B), on the other hand, deals with rent that relates to a period of  
26 time that has already passed. Thus, the language modifying "rent,"

1 that the rent be due and unpaid, relates to the time frame during  
2 which the debtor became liable for the rent. Lessor's arguments do  
3 not convince me that Congress intended any different definition or  
4 test for "rent" as used in § 502(b)(6)(A) and § 502(b)(6)(B).  
5 Therefore, in determining what damages will qualify as rent under  
6 subparagraph (B), I will apply the same test set out in McSheridan  
7 for "rent reserved" under subparagraph (A).

8 It is not clear to the court whether lessor's claim includes  
9 any damages that would fit within the language of § 502(b)(2)(B).  
10 To the extent lessor claims damages that are appropriately  
11 classified as rent that was due and unpaid when debtor filed its  
12 petition, those damages would be within the cap. At this point in  
13 the case, however, there is no evidence that lessor is claiming such  
14 damages. Nor did it seek summary judgment on the § 502(b)(6)(B)  
15 issue. Therefore, lessor is not entitled to summary judgment on  
16 that issue.

17 3. Is lessor required to accept the surrendered property in "as  
18 is" condition?

19 Debtor asks for a ruling that its surrender of the premises  
20 is governed by the "as is" provision of the amended lease. Lessor  
21 argues that the "as is" provision was never triggered in this case,  
22 because a condition to its applicability never occurred.

23 Paragraph 7 of the Amendment to Lease replaced the original  
24 lease surrender provision. Paragraph 7 provides:

25 "In the event Lessor does not require Lessee to purchase the  
26 Leasehold Estate as provided by paragraph 32(b) of the  
Amended Lease, Lessee shall peaceably and quietly leave,

1 yield up and surrender the Leased Property unto Landlord 'as  
2 is' in its then current condition, and Landlord agrees to  
3 accept the Leased Property in such condition. Nothing  
4 contained in this paragraph is intended to modify, limit or  
5 otherwise affect Lessee's obligation to maintain, repair and  
6 replace the Leased Property as provided in the Lease."

7 Paragraph 32(b), as amended by the Amendment to Lease, provides:

8 "Lessee shall, at the request of Lessor delivered no later  
9 than August 1, 1997, purchase the Leasehold Estate from  
10 Lessor on the First Option Expiration Date \* \* \*."

11 Debtor's position is that lessor did not request that debtor  
12 purchase the property, which it had the opportunity to do anytime  
13 before August 1, 1997, and therefore paragraph 7 applies to debtor's  
14 obligations on surrender of the property. Lessor's position is that  
15 it had until August 1, 1997 to exercise its option to require debtor  
16 to purchase the property, and that debtor made it impossible for  
17 lessor to exercise that option when it rejected the lease in 1995.  
18 Therefore, according to lessor, the "as is" provision was never  
19 triggered.

20 I agree with lessor. The two provisions of the amended  
21 lease, read together, indicate that the parties intended that, as of  
22 the first option expiration date, which was January 31, 1998, the  
23 debtor would either purchase the property or surrender it to lessor  
24 "as is." Neither of the provisions deal with the possibility of  
25 surrender at a time earlier than the first option expiration date.  
26 Surrender at a time other than the time contemplated in paragraph 7  
of the Amendment to Lease is not governed by that paragraph, and the  
"as is" provision does not apply to debtor's obligation when it  
surrendered the leased property after rejection and before January

1 31, 1998. Debtor is not entitled to a ruling that lessor was  
2 required to accept the return of the property "as is."

3 4. Is lessor entitled to offset or recoupment?

4 Debtor seeks a ruling that it is entitled to reduce the  
5 amount of lessor's allowed claim by the amount of rent debtor  
6 prepaid before it filed its petition and that the amount debtor owes  
7 lessor on any allowed claim will be reduced by the value of the  
8 balance due under the promissory note. Lessor seeks a ruling that  
9 lessor can recoup against amounts it owes to debtor on the note all  
10 of lessor's damages, regardless of any § 502(b)(6) limitation.

11 a. Prepaid rents.

12 Debtor argues that it is entitled to reduce the amount of  
13 lessor's allowed claim by the amount of rent it prepaid before it  
14 rejected the lease, which it asserts is \$26,811.17. Lessor responds  
15 that it does not oppose reducing the amount of its allowed claim by  
16 the prepaid rent, to the extent § 553 permits offset by debtor and  
17 if the court awards lessor damages. Lessor does not argue that  
18 debtor is not entitled to offset the prepaid rent. Accordingly,  
19 debtor is entitled to an order allowing it to offset the prepaid  
20 rent against any amount that may later be determined to be lessor's  
21 allowed claim.

22 b. Promissory note.

23 In January, 1994, lessor executed a promissory note under  
24 which it agreed to pay debtor \$515,000. Debtor asks for a holding  
25 that the amount of any allowed claim of lessor should be reduced by  
26 the present value of the balance due under the note, which it

1 represents is \$332,744.67. Lessor asks me to hold that it may  
2 recoup against amounts due on the note all of its damages caused by  
3 debtor's breach of the lease, regardless of any limitation on the  
4 claim pursuant to § 502(b)(6).

5 Debtor argues that any offset to which lessor might be  
6 entitled against the amount lessor owes on the promissory note is  
7 limited under 11 U.S.C. § 553 to the amount of the allowed claim.<sup>5</sup>  
8 Lessor does not dispute that offset is limited by § 553 to the  
9 amount of the allowed claim, but argues that it is entitled to  
10 recoupment, which is not limited to the amount of the allowed claim.

11 In In re Harmon, 188 BR 421, 424-25 (9th Cir BAP 1995), the  
12 BAP explained offset and recoupment:

13 "Setoff and recoupment originated as equitable rules of  
14 joinder to expand the strict rules of pleading under the  
15 common law, allowing creditors to offset mutual and  
reciprocal debts with the debtor. In bankruptcy, the  
doctrine of setoff is governed by § 553 \* \* \*.

16 \* \* \* \* \*

17 "Setoff allows adjustments of mutual debts arising out of  
18 separate transactions between the parties. Recoupment, on  
the other hand, involves a netting out of debt arising from a

19  
20 <sup>5</sup> Section 553(a)(1) provides:

21 "(a) Except as otherwise provided in this section \* \*  
22 \*, this title does not affect any right of a  
creditor to offset a mutual debt owing by such  
creditor to the debtor that arose before the  
23 commencement of the case under this title against a claim of  
such creditor against the debtor that arose before the  
24 commencement of the case, except to the extent  
25 that --

26 "(1) the claim of such creditor against the debtor is  
disallowed."

1           single transaction. \* \* \*

2           Thus, recoupment is the setting up of an obligation arising from the  
3           same transaction as the plaintiff's claim as a means of reducing or  
4           eliminating the claim. In re Photo Mechanical Services, Inc., 179  
5           BR 604, 612 (Bankr D Minn 1995); 4 Collier on Bankruptcy ¶ 553.03  
6           (15th ed 1996). It differs from offset in that offset requires  
7           mutual obligations, while recoupment requires that the obligations  
8           have arisen from the same transaction. Lee v. Schweiker, 739 F2d  
9           870, 875 (3d Cir 1984).

10           Debtor acknowledges that the obligations on the lease and on  
11           the note arose from the same transaction. It argues that recoupment  
12           does not apply, because recoupment applies only when there has been  
13           an overpayment, and here there is no overpayment. In re Photo  
14           Mechanical Services, Inc., 179 BR at 613.

15           I disagree with the court in Photo Mechanical Services that  
16           recoupment applies only when there has been an overpayment.  
17           Although I agree with the court that the typical situation for  
18           application of recoupment involves an overpayment, 179 BR at 613,  
19           the fact that an overpayment is typically involved does not make an  
20           overpayment a requirement for application of the doctrine. Most  
21           courts require only that the obligations arise out of the same  
22           transaction. E.g., Lee v. Schwieker, 739 F2d at 875; In re Harmon,  
23           188 BR at 425. I will follow the majority rule.

24           The next question is whether recoupment may be asserted  
25           against the entire rent rejection claim or whether it applies only  
26

1 to the amount of the allowed claim. In bankruptcy, the doctrine of  
2 setoff is governed by § 553, which among other things limits the  
3 amount of offset to the amount of a creditor's allowed claim. 11  
4 U.S.C. § 553(a)(1). Recoupment, on the other hand, is not addressed  
5 in the Bankruptcy Code, but was adopted in bankruptcy by court  
6 decision. Lee v. Schweiker, 739 F2d at 875. Thus, there are no  
7 statutory limits on recoupment as there are on offset. The fact  
8 that Congress has specifically limited the right of offset and has  
9 not limited recoupment indicates an intention that recoupment not be  
10 limited. The courts are in agreement that recoupment is not subject  
11 to the limitations of § 553. E.g., In re Harmon, 188 BR at 425; Lee  
12 v. Schweiker, 739 F2d at 875; In re Hiler, 99 BR 238, 243 (Bankr DNJ  
13 1989); In re Klingberg Schools, 68 BR 173 (ND Ill 1986), aff'd 837  
14 F2d 763 (7th Cir 1988). Debtor has not provided any persuasive  
15 reason for limiting recoupment to those portions of lessor's claim  
16 that are ultimately allowed. I will follow those cases that hold  
17 that it would be inequitable to apply the limitations on setoff to  
18 recoupment. In re Harmon, 188 BR at 425; In re Hiler, 99 BR at 243.

19 At the hearing on these motions, debtor asserted that it has  
20 a right to recoup against amounts lessor claims for damages arising  
21 from debtor's lease of the property, and asked for a determination  
22 of how that right of recoupment would be applied. Specifically,  
23 debtor seeks a ruling regarding whether the amount lessor owes  
24 debtor on the note will be deducted from the full amount of lessor's  
25 claim, including any amount that exceeds the cap of § 502(b)(6), or  
26 whether it will be deducted first from the amount of the allowed

1 claim.

2 I have not found any authority directly addressing this  
3 issue. As I have explained above, recoupment is the setting of an  
4 obligation arising from the same transaction as a means of reducing  
5 or eliminating the debt. In re Photo Mechanical Services, Inc., 179  
6 BR at 612. It has no greater effect than a defense to the claim.  
7 Its function is to reduce the amount demanded, and goes to the  
8 justice of the claim. In re Harmon, 188 BR at 425; In re Hiler, 99  
9 BR at 245. A party asserting recoupment cannot obtain an  
10 affirmative judgment for any amount owed to it over and above the  
11 amount of the claim asserted against it. Id.

12 In this case, lessor has asserted a claim for damages, which  
13 the parties appear to agree will exceed the allowable cap set by §  
14 502(b)(6). As a defense to that claim, debtor can assert a right to  
15 recoup the amount lessor owes it on the note, up to the amount of  
16 lessor's claim. Lessor's claim is for the full amount of damages  
17 caused by debtor's breach of the contract as a result of rejecting  
18 the contract in bankruptcy. That claim is arbitrarily capped by §  
19 502(b)(6), which Congress included in the Bankruptcy Code to prevent  
20 a claim so large as to prevent other general unsecured creditors  
21 from receiving a dividend from the estate. In re Mr. Gatti's, Inc.,  
22 162 BR at 1009 n 4; In re Storage Technology, Corp., 77 BR at 825.

23 Debtor's defense of recoupment is a defense to lessor's  
24 entire claim, not just to the portion of the claim that the  
25 Bankruptcy Code has arbitrarily limited in order to protect other  
26 unsecured creditors. As a matter of fairness, debtor's recoupment



1 should apply to the full amount of the claim, which after all  
2 reflects an obligation that would be included in lessor's allowed  
3 claim but for the limitation placed on the claim in bankruptcy. If  
4 there is a balance left after reducing the claim by the amount  
5 lessor owes to debtor, then lessor can assert that claim, up to the  
6 cap set by § 502(b)(6).

7 Therefore, the procedure for recoupment should be (1)  
8 determine the full amount of lessor's claim; (2) reduce that amount  
9 by the amount lessor owes to debtor on the note (but only to the  
10 amount of the lessor's claim); and (3) allow lessor's claim for the  
11 remainder up to the statutory cap set by § 502(b)(6).

#### 12 CONCLUSION

13 The parties' requests for summary judgment in this matter  
14 have been a moving target. Positions have changed throughout the  
15 briefing. I will summarize my ruling by reference to debtor's reply  
16 memorandum, to lessor's opening and reply memoranda, and to the page  
17 number in this opinion where the ruling appears. First, as to  
18 debtor's motion for summary judgment, its request for an order:

19 1. that lessor's claim for damages is governed by § 502(b)(6) is  
20 granted. Opinion at 5-6.

21 2. that the damage cap set forth in § 502(b)(6) encompasses all  
22 damages arising from the breach of any and all lease covenants is  
23 granted. Opinion at 11.

24 3. that "rent reserved" will be determined by the three-part  
25 test set out in In re McSheridan is granted. Opinion at 10.

26 4. that certain expenses do not qualify as rent reserved, namely

1 canopy erection and brick removal, ice and water removal, treatment  
2 of ammonia and calcium chloride, security guards, boarding up,  
3 environmental testing and management and cleanup supervisory fees,  
4 is denied. Opinion at 10.

5 5. that the amount of lessor's allowed claim be reduced by the  
6 amount of postpetition prepaid rent is granted. Opinion at 19.

7 6. that the amount of lessor's allowed claim be reduced by the  
8 present value of the balance due to debtor on the promissory note is  
9 denied. Opinion at 21-22.

10 7. that lessor's claim cannot include costs arising as a result  
11 of alleged liability under CERCLA and RCRA is denied. Opinion at  
12 13.

13 8. that lessor's claim cannot include costs for alleged  
14 violations of ¶ 4(a)(vi) and 13 of the lease is denied. Opinion at  
15 9-10.

16 9. that expenses for ice and water removal, treatment of ammonia  
17 and calcium chloride, security guards, boarding up, electricity,  
18 environmental testing and insurance do not arise from the lease is  
19 denied. Opinion at 9-10.

20 10. that lessor's claim against debtor is limited to damages  
21 accruing after January 2, 1994 is denied, because it is not clear  
22 whether debtor is liable for any damages that would be subject to  
23 that limitation. Opinion at 9-10.

24 11. that debtor was required to surrender the warehouse in an "as  
25 is" condition and lessor was required to accept the warehouse in  
26 that condition is denied. Opinion at 18.

As to lessor's motion for summary judgment, its request for an order:

1. that lessor's damages resulting from rejection are not limited by § 502(b) (6) is denied. Opinion at 5-6.

2. that all claims arising under paragraphs 3 and 4 of the lease are rent reserved is denied. Opinion at 10.

3. that lessor's claim for damages arising from events other than termination of the lease is not limited by § 502(b)(6) is denied. Opinion at 11.

4. that damages caused by debtor's alleged breach of duties not arising under the lease are not limited by § 502(b)(6) is granted. Opinion at 13-14.

5. that lessor is entitled to recoup against any amounts due debtor under the note all of lessor's damages, without the limitation of § 502(b)(6), is granted. Opinion at 21-22.

This Memorandum Opinion shall constitute Findings of Fact and Conclusions of Law as required by Fed. R. Bankr. P. 7052 and 9014 and they shall not be separately stated. Ms. Devery should submit an order consistent with this Memorandum Opinion.

ELIZABETH L. PERRIS  
Bankruptcy Judge